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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 392

SIDNEY C. KLEINMAN and JANICE R. KLEINMAN,
Petitioners-Objectors,
vs.
HYMAN SAMINSKY and BETTY SIEGEL, Trustee for JOAN C. SIEGEL,
and
Respondents-Plaintiffs,
CHARLES C. ABBOTT, WILFRED GODFREY, J. LEE POTTER, ORA C. ROEHL, ERWIN H. SCHELL, SIDNEY L. SHOLLEY, CAMERON S. THOMPSON, SAM G. BAGGETT, GLENN N. LEMPEREUR, KEYSTONE CUSTODIAN FUNDS, INC., KEYSTONE CUSTODIAN FUNDS, INC., as Trustee, and THE KEYSTONE COMPANY OF BOSTON,
Respondents-Defendants.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF DELAWARE

BRIEF FOR RESPONDENTS-DEFENDANTS IN OPPOSITION

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September 15, 1964

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Opinions Below

The opinion of the Delaware Supreme Court (Pet. 1a) is reported at 194 A. 2d 549. The opinion of the Dela-

ware Court of Chancery (PA63)* is reported at 194 A. 2d 549.

The Question Presented

Was the approval by the courts below of a settlement of a class action involving an investment company a proper exercise of business judgment?

Statutory Provisions

The pertinent provisions of the Investment Company Act of 1940, 15 U.S.C. §80a, are set forth in an appendix to this brief.

Statement

The Delaware Supreme Court and Court of Chancery have approved "as a matter of business judgment" (Pet. 9a, PA70) the settlement of a class action brought by several holders of certificates of participation in the Keystone Custodian Funds. Notice of the proposed settlement was given to the Funds' 230,000 certificateholders and only petitioners, a lawyer and his wife, objected. Petitioners ask this Court to review the business judgment exercised by the Delaware courts in approving the settlement, claiming that the approval was based upon a misconception of the Investment Company Act.

The ten Keystone Custodian Funds are common law "Massachusetts trusts", each existing under a separate trust instrument. The trusts were created in 1935; after enactment of the Investment Company Act of 1940, 15 U.S.C. §80a, each Fund registered with the Securities and

* References to Petitioners' Appendix in the Delaware Supreme Court are abbreviated "PA". References to Respondents-Defendants' Appendix in the Delaware Supreme Court are abbreviated "RA".

Exchange Commission under that Act as an open-end investment company or mutual fund (RA4).

The trustee of each Fund is respondent Keystone Custodian Funds, Inc. ("Keystone") which, pursuant to the terms of the trust instruments, performs all of the investment management and administrative services required by the Funds (RA2, pp. 8-9). The trust instruments provide for the payment to the trustee of a management fee of ½ of 1% annually on the first $150 million in aggregate Fund assets and ⅜ of 1% annually on aggregate Fund assets in excess of that amount. The trust instruments provide further for the payment of a "recurring charge" of ¼ of 1% annually in lieu of all operating and administrative expenses (RA2, p. 4).*

Each of the ten Funds has a separate portfolio and a distinct investment policy (RA1-2, 76, p. 3). Certificates of participation in each of the Funds are offered for sale to the public in accordance with the terms of a principal underwriting contract between Keystone, the trustee, and the respondent Keystone Company of Boston ("Keystone-Boston"), a wholly owned subsidiary of Keystone.

The Complaint

The complaint, as amended (PA16), alleges that the management fee and recurring charge specified in the trust instruments are excessive and a waste of the Funds' assets, challenges the validity of the underwriting contract between Keystone and Keystone-Boston and complains of the manner in which brokerage commissions are allocated with respect to transactions in the portfolio securities of the Funds.

* The management fee and recurring charge with respect to Series B-1, a high-grade bond fund, are half those paid by the other nine funds. Under the proposed settlement, the B-1 management fee and recurring charge will continue to be half that charged the other funds.

Ratification by the Funds' Certificateholders

While this action was pending in the trial court, the certificateholders of all ten Keystone Funds voted overwhelmingly to ratify and approve all payments of management fees and recurring charges made to Keystone pursuant to the provisions of the trust instruments. The certificateholders further approved a new underwriting contract between Keystone and Keystone-Boston and ratified and approved all past underwriting contracts and transactions thereunder (RA82-89).

More than 90% of the certificateholders of each Fund—including petitioners (RA106)—voted for ratification (RA90-91).

The proxy statement, on the basis of which the certificateholders ratified the matters now complained of, fairly described the complaint in this action and stated that ratification, if given, "will be asserted in defense of the litigation" (RA80, p. 2). All payments to Keystone and Keystone-Boston were stated in detail for a number of years (pp. 3-4). Complete financial statements were given both for Keystone and Keystone-Boston (pp. 6-7). Keystone's directors were identified and their stock holdings in Keystone were given (p. 5). Their affiliations with Keystone were reported, as was the fact that all but two were defendants in this action (p. 5).

Petitioner Sidney C. Kleinman is a lawyer (RA94). He could hardly be heard to say that he did not understand the proxy statement or the significance of the proxy of ratification which he signed.

The Settlement

The most common fee for management services in the investment company industry is a "flat" ½ of 1% annually of the fund's average net assets (Hearing Ex. 3). In

addition, almost every fund bears some expenses of operation in addition to the management fee (RA47).

Even prior to the settlement, the Keystone management fee was substantially less than the standard flat ½ of 1%; it was ⅜ of 1% on so much of the aggregate net assets of all ten Funds as exceeded $150 million (RA53-54).

The Keystone Funds bear none of their expenses of operation (RA47, 60-61). In lieu thereof, they pay a "recurring charge" to Keystone, the trustee, which assumes responsibility for all operating expenses (RA2, p. 4). Prior to the settlement, the recurring charge was ¼ of 1% annually of the aggregate net assets of the ten Funds (RA53).

The settlement provides for reductions in the management fee and recurring charge. The new management fee and recurring charge are (RA36-37):

Aggregate Assets of 10 Funds (millions of dollars)	Management Fee Rate	Recurring Charge Rate
First $150	0.5 %	0.25 %
$150 to $500	0.375%	0.25 %
$500 to $750	0.35 %	0.175%
$750 to $1,000	0.325%	0.16 %
$1,000 to $1,250	0.3 %	0.15 %
Over $1,250	0.275%	0.14 %

At the time of the settlement hearing, the net assets of the ten Keystone Funds were $771,000,000; at that asset figure, the settlement would yield an annual saving to the Funds in excess of $250,000 (PA68).

This annual saving, of course, will increase as the Funds grow in size. The following schedule shows the saving

which would accrue to the ten Funds in the aggregate, at varying asset levels, by reason of the settlement:*

Asset Level in hundreds of millions of dollars	Management Fee		Recurring Charge		Total		Saving to Funds
	Present	Proposed	Present	Proposed	Present	Proposed	
500	2,062,500	2,062,500	1,250,000	1,250,000	3,312,500	3,312,500	—
600	2,437,500	2,412,500	1,500,000	1,425,000	3,937,500	3,837,500	100,000
700	2,812,500	2,762,500	1,750,000	1,600,000	4,562,500	4,362,500	200,000
750	3,000,000	2,937,500	1,875,000	1,687,500	4,875,000	4,625,000	250,000
800	3,187,500	3,100,000	2,000,000	1,767,500	5,187,500	4,867,500	320,000
900	3,562,500	3,425,000	2,250,000	1,927,500	5,812,500	5,352,500	460,000
1,000	3,937,500	3,750,000	2,500,000	2,087,500	6,437,500	5,837,500	600,000

Apart from savings measurable directly in dollars, the settlement would give to the certificateholders the permanent right to reject any increase in compensation proposed by the trustee. And for a period of eight years, the trustee could not seek any increase in compensation except in the event of a substantial change in circumstances which made its compensation unreasonably low in relation to services rendered and the Chancellor granted leave to the trustee to submit the proposed increase to the certificateholders (PA38).

Notice of the proposed settlement was given pursuant to order of the court to all certificateholders of the Funds (RA33). Of more than 230,000 certificateholders, only petitioners objected to the settlement.

* As already noted, the B-1 Fund would continue to pay a management and recurring charge at half the prescribed rate. The figures given above assume that B-1 would pay the same fee and recurring charge as the other Funds; any other basis of computation would require an assumption with respect to B-1's assets. However, the figures in the final column are not affected. The assets of the B-1 Fund as of December 31, 1962 were $6.8 million (Hearing Ex. 3).

The Decision Below

After a hearing on notice to all certificateholders of the Funds and after consideration of petitioners' evidence and the entire record in the case, the Chancellor concluded that "as a matter of business judgment, • • • the settlement is fair and reasonable in the present setting and will be approved" (PA70).

The Chancellor painstakingly reviewed petitioners' contentions, noting the "difficulties plaintiffs would face if the matter were to proceed to a final hearing" (PA69). The Chancellor observed that even assuming the validity of legal contentions advanced by petitioners and by plaintiffs, the right to recover damages "is by no means clear" (PA70).

On appeal by petitioners, the Supreme Court of Delaware held that "the approval of the settlement by the Chancellor was a proper exercise of business judgment" (Pet. 9a).

Argument

1. The Delaware judgment which petitioners seek to review decided no question of law and certainly no substantial question of federal law. All that was decided was that a settlement negotiated by the parties was, *as a matter of business judgment*, fair and reasonable. In considering a proposed settlement of a class action, the court does not decide the contentions of either party. As the Delaware Supreme Court has said of its function in these circumstances,

> "The function of the court is discharged, however, when the nature of the claim, the possible defenses to it, the legal and factual obstacles facing the plaintiff in the event of trial are weighed and considered. If, in the light of these matters, the court

> approves the settlement as reasonable through the exercise of sound business judgment, its function as the so-called third party to the settlement has been discharged." *Rome* v. *Archer*, 197 A. 2d 49 (Del. 1954).

Petitioners thus wholly misconceive the nature of a settlement when they contend that there has been an erroneous decision on a substantial question of federal law. Indeed, the Delaware Supreme Court indicated that it would have approved the settlement even if it appeared that there was some merit to petitioners' contentions; the Court said (Pet. 9a) that comparison of the Keystone fees with those paid by other investment companies "alone • • • justifies approval of the settlement". Moreover, the prior certificateholder ratification of the transactions challenged by the complaint and petitioners' own proxy of ratification might in themselves preclude objection by petitioners.

2. The federal question which petitioners pose is so narrow in its scope that very probably it concerns no investment company other than the Keystone Funds. It is incorrect to state, as petitioners do (Pet. 3, 10), that the question affects one-fourth of all the mutual funds in the United States. Petitioners rely for this erroneous assertion of public importance upon *A Study of Mutual Funds*, H. Rep. No. 2274, 87th Cong., 2d Sess. (1962), a report on the investment company industry which was submitted to the Congress by the Securities and Exchange Commission. It appears from the study that while about one-fourth of the country's investment companies are trusts (*Id.* at p. 6), only ten (including the Keystone Funds as a single unit) have *corporate* trustees.* The remaining trustees are natural persons (*Id.* at p. 46) and

* The Keystone Funds are the only large trusts having a corporate trustee. See *A Study of Mutual Funds*, p. 47.

petitioners agree that natural persons who serve as trustees (not being "investment advisers" within the meaning of the Investment Company Act) may do so without violation of the Act. As to the nine other funds which are served by corporate trustees, the study does not indicate whether those funds have boards of directors so constituted as to comply with petitioners' strained reading of the Act. Finally, there is no substance whatever to petitioners' suggestion that "the Act may be evaded today" by the creation of an investment company in trust form (Pet. 10). Section 16 of the Act requires that fund directors, even in the case of a common law trust, be elected by certificateholders; the only trusts which are exempt from this provision are those, like Keystone, which were "existing on the date of enactment of this title" (§16(b)).

3. Petitioners contend that Keystone, the corporate trustee of the ten Keystone Funds, is the Funds' "investment adviser" within the meaning of Section 2(a)(19) of the Investment Company Act and that the board of directors of the corporate trustee is in fact the board of directors of each of the ten Funds. Therefore, petitioners argue, the board's constitution is unlawful under Section 10(a) of the Act, which provides that no more than 60% of a fund's board of directors may consist of persons who are affiliated with the fund's investment adviser. If Keystone is indeed an "investment adviser", Section 15 of the Act would require that its retention be approved periodically either by a properly constituted board of directors of the Funds *or* by the Fund's certificateholders.

Petitioners' circular contention is a distortion of the Investment Company Act and is, in any event, irrelevant here.

(a) Even if Keystone, the corporate trustee, were an "investment adviser", it could lawfully continue in that capacity so long as its continuance was approved periodically by certificateholders of the Funds in accordance with Section 15 of the Act. Thus, even if petitioners are correct in their contention that the trustee is an "investment adviser", there would be nothing inherently unlawful in the structure of the Funds.

(b) Keystone is not an "investment adviser" as that term is defined in Section 2(a)(19) of the Act, which provides in relevant part as follows:

> "'Investment adviser' of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company. * * *."

Keystone is admittedly a "trustee", but petitioners argue that only natural persons qualify for the "trustee" exemption. However, petitioners ignore Section 2(a)(27) of the Act, which defines "person" as used in the Act to mean "a natural person or a company". Thus, the person who may be a trustee under Section 2(a)(19) may be a natural person or a company. It is significant that *A Study of Mutual Funds*, the report upon which petitioners rely, states categorically that Keystone is "legally trustee under deeds of trust rather than an adviser" (*Id.* at p. 441).

(c) The record shows that the Securities and Exchange Commission, which is charged with the administration and enforcement of the Investment Company Act, does not agree with petitioners' contention that Keystone has been serving unlawfully as an investment adviser for over 20 years. Keystone's structure was reviewed in detail with the Commission staff after passage of the Act (RA4-11) and technical questions arising out of Keystone's trust form were under frequent review thereafter (RA21-26). Moreover, Keystone's structure is necessarily laid bare in annual prospectuses (RA76), which cannot become effective except by order of the Commission, and in proxy statements (*e.g.*, RA80), which must be filed with the Commission prior to distribution. In the unlikely event that the Commission may one day come to share petitioners' view of the Act, the judgment approving the settlement of this case could not bar the Commission from seeking appropriate injunctive and other relief under Section 42(e) of the Act.

4. The decisions cited in the petition (pp. 17-20) are not even remotely relevant. There is no conflict between the approval of the settlement by the courts below and any decision anywhere which has been brought to our attention.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be denied.

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APPENDIX

Investment Company Act of 1940, 15 U.S.C. §80a

Definitions

2(a) (19) "Investment adviser" of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company . . .

(27) "Person" means a natural person or a company.

Affiliations of Directors

SEC. 10. (a) After one year from the effective date of this title, no registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

(h) In the case of a registered management company which is an unincorporated company not having a board of directors, the provisions of this section shall apply as follows:

(1) the provisions of subsection (a), as modified by subsection (e), shall apply to the board of directors of the depositor of such company;

(2) the provisions of subsections (b) and (c), as modified by subsection (e), shall apply to the board of directors of the depositor and of every investment adviser of such company.

. . . . .

Investment Advisory and Underwriting Contracts

SEC. 15. (a) After one year from the effective date of this title it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

• • • • •

(c) In addition to the requirements of subsections (a) and (b) it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect

prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.

* * * * *

(e) In the case of a common-law trust of the character described in subsection (b) of section 16, either written approval by holders of a majority of the outstanding shares of beneficial interest or the vote of a majority of such outstanding shares cast in person or by proxy at a meeting called for the purpose shall for the purposes of this section be deemed the equivalent of the vote of a majority of the outstanding voting securities, and the provisions of paragraph (40) of section 2 (a) as to a majority shall be applicable to the vote cast at such a meeting.

(f) Nothing contained in this section shall be deemed to require or contemplate any action by an advisory board of any registered company or by any of the members of such a board.

Changes in Board of Directors; Provisions Relative to Strict Trusts

SEC. 16. (a) No person shall serve as a director of a registered investment company unless elected to that office, by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose; except that vacancies occurring between such meetings may be filled in any otherwise legal manner

if immediately after filling any such vacancy at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting. In the event that at any time less than a majority of the directors of such company holding office at that time were so elected by the holders of the outstanding voting securities, the board of directors or proper officer of such company shall forthwith cause to be held as promptly as possible and in any event within sixty days a meeting of such holders for the purpose of electing directors to fill any existing vacancies in the board of directors unless the Commission shall by order extend such period. The foregoing provisions of this subsection shall not apply to members of an advisory board.

Nothing herein shall, however, preclude a registered investment company from dividing its directors into classes if its charter, certificate of incorporation, articles of association, by-laws, trust indenture, or other instrument or the law under which it is organized, so provides and prescribes the tenure of office of the several classes: *Provided,* That no class shall be elected for a shorter period than one year or for a longer period than five years and the term of office of at least one class shall expire each year.

(b) The provisions of subsection (a) of this section shall not apply to a common-law trust existing on the date of enactment of this title under an indenture of trust which does not provide for the election of trustees by the shareholders. No natural person shall serve as trustee of such a trust, which is registered as an investment company, after the holders of record of not less than two-thirds of the outstanding shares of beneficial interest in

such trust have declared that he be removed from that office either by declaration in writing filed with the custodian of the securities of the trust or by votes cast in person or by proxy at a meeting called for the purpose. Solicitation of such a declaration shall be deemed a solicitation of a proxy within the meaning of section 20 (a).

The trustees of such a trust shall promptly call a meeting of shareholders for the purpose of voting upon the question of removal of any such trustee or trustees when requested in writing so to do by the record holders of not less than 10 per centum of the outstanding shares.

Whenever ten or more shareholders of record who have been such for at least six months preceding the date of application, and who hold in the aggregate either shares having a net asset value of at least $25,000 or at least 1 per centum of the outstanding shares, whichever is less, shall apply to the trustees in writing, stating that they wish to communicate with other shareholders with a view to obtaining signatures to a request for a meeting pursuant to this subsection (b) and accompanied by a form of communication and request which they wish to transmit, the trustees shall within five business days after receipt of such application either—

(1) afford to such applicants access to a list of the names and addresses of all shareholders as recorded on the books of the trust; or

(2) inform such applicants as to the approximate number of shareholders of record, and the approximate cost of mailing to them the proposed communication and form of request.

If the trustees elect to follow the course specified in paragraph (2) of this subsection (b) the trustees, upon the written request of such applicants, accompanied by

a tender of the material to be mailed and of the reasonable expenses of mailing, shall, with reasonable promptness, mail such material to all shareholders of record at their addresses as recorded on the books, unless within five business days after such tender the trustees shall mail to such applicants and file with the Commission, together with a copy of the material to be mailed, a written statement signed by at least a majority of the trustees to the effect that in their opinion either such material contains untrue statements of fact or omits to state facts necessary to make the statements contained therein not misleading, or would be in violation of applicable law, and specifying the basis of such opinion.

After opportunity for hearing upon the objections specified in the written statement so filed, the Commission may, and if demanded by the trustees or by such applicants shall, enter an order either sustaining one or more of such objections or refusing to sustain any of them. If the Commission shall enter an order refusing to sustain any of such objections, or if, after the entry of an order sustaining one or more of such objections, the Commission shall find, after notice and opportunity for hearing, that all objections so sustained have been met, and shall enter an order so declaring, the trustees shall mail copies of such material to all shareholders with reasonable promptness after the entry of such order and the renewal of such tender.

Enforcement of Title

42 (e) Whenever it shall appear to the Commission that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this title, or of any rule, regulation, or order

hereunder, it may in its discretion bring an action in the proper district court of the United States, or the proper United States court of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices and to enforce compliance with this title or any rule, regulation, or order hereunder. Upon a showing that such person has engaged or is about to engage in any such act or practice, a permanent or temporary injunction or decree or restraining order shall be granted without bond. In any proceeding under this subsection to enforce compliance with section 7, the court as a court of equity may, to the extent it deems necessary or appropriate, take exclusive jurisdiction and possession of the investment company or companies involved and the books, records, and assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, who with the approval of the court shall have power to dispose of any or all of such assets, subject to such terms and conditions as the court may prescribe. The Commission may transmit such evidence as may be available concerning any violation of the provisions of this title, or of any rule, regulation, or order thereunder, to the Attorney General, who, in his discretion, may institute the appropriate criminal proceedings under this title.